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Re: The Application of Limits to Offsets and Their Use under California's AB 32

Dear Brienne Aguila and Staff of the California Air Resources Board:

On behalf of EcoSecurities, a world leader in the development of greenhouse gas (GHG) emission reduction projects with two offices in California, we thank you for the opportunity to comment on the application of limits to offsets and their use under AB 32. We acknowledge that implementation of the Scoping Plan has and will continue to be a significant task, and we applaud you for your diligent work and transparent processes to date. We hope our efforts will contribute to the development of climate policies in California that are environmentally effective and administratively straightforward.

Our comments today focus on two issues: the numerical limitation of offsets, and the application of that limit. We will begin by discussing why we believe the existing quantitative limits as outlined in the Scoping Plan should not be pushed back any further.

EcoSecurities opposes quantitative offset limits in theory but understands the importance of using offsets as a tool to supplement emission reductions occurring at the source of a capped entity. We also understand limiting offsets out of the necessity to gather broad stakeholder acceptance for a cap-and-trade program. However, California's Scoping Plan has already imposed significant quantitative limits by restricting offsets to 49% of the overall reductions required in the program, and this number should not be pushed back any further. In addition, using a value of 49% to represent the total offset limit prevents a clear and precise understanding of just how small the offsets component to AB 32 actually is—5% on average of the program from 2012-2020—and could result in a misinterpretation by stakeholders, the media, and other important parties.

The severity of California's offset limits is already incongruous with both a) what is likely in legislation at the federal level and b) growing political consensus amongst a broad base of core stakeholders. Under the Waxman-Markey bill, approximately 30% offsets are allowed (as a percent of the overall emissions budget in the program), half domestic and half international, and this percentage increases towards the

later years of the program. The US Climate Action Partnership (USCAP), broadly recognized as one of the most important coalitions on climate change policy in the US, and which brings together members from some of America's largest corporations and NGOs, has supported a robust federal offsets program with a 2 billion offset pool—1 billion each of domestic and international. This is consistent with the Waxman-Markey draft legislation, again, equating to approximately 30% offsets (as a percent of the overall emissions budget in the program) beginning in 2012.

Further limits on the offsets program in California is likely to dry up offset supply entirely. As a project developer, EcoSecurities is familiar with the costs to develop projects under new rules and in new jurisdictions. If the allowable pool of offsets in California is too small, there will be little incentive to build capacity to access it, and capital will flow elsewhere. EcoSecurities would encourage California to expand the allowable use of offsets in the State. At the very least, existing limitations should be held strong and not pushed back further.

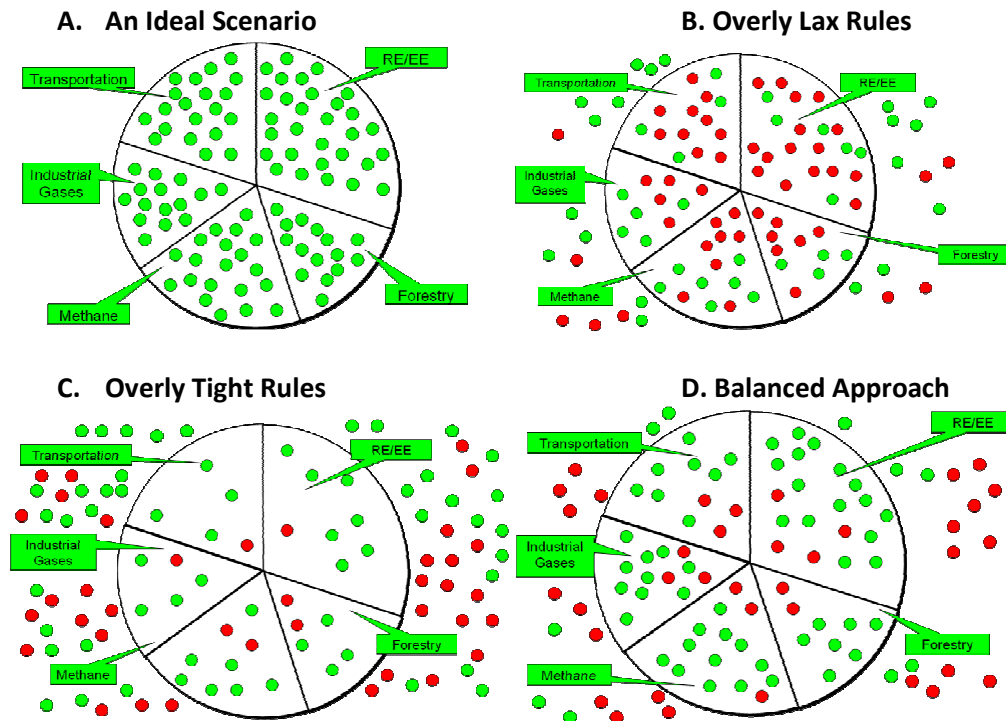
Quantitative limits on the use of offsets bring no economic or environmental benefits and, like geographic limits, should be avoided in favor of rigorous standards for environmental integrity. Stringent standards will ensure that only additional, high-quality offsets can be used for compliance. High standards will in turn provide a natural limit on the total number of offsets allowed, as a result of market forces. The introduction of artificial limits only invites market distortion and limits the flexibility of the emissions reductions program, unnecessarily increasing overall compliance costs.

Finally, arbitrary quantitative limits reduce the size of the offsets pool, but do nothing to change the proportion of low-quality credits that get through. The objective of reducing emissions would be far better served by holding an unrestricted pool of credits to rigorous standards, thereby increasing the number of high quality offsets representing real emissions reductions. This would enhance the environmental integrity of the system while avoiding harmful perversions of the market (See Figure 3).

To be clear, EcoSecurities is not opposed to the concept of complementarity¹, so long as it is based on a robust understanding of the market and the forces of supply and demand. In particular, a complementarity rule should not be so stringent as to discourage the development of offset projects by introducing unnecessary uncertainty and dampening demand signals.

¹ Complementarity allows that offsets will be used to supplement domestic action to fight global warming.

Figure 3. Additionality of Offset Projects Under Various Scenarios Where Limits Are Imposed.
(Green dots represent environmentally additional projects; red dots indicate non-additional projects.)



California has discussed three possible mechanisms for applying a limit to the size of the offset pool in California. These mechanisms as outlined by staff in ARB's meeting from March 23, 2009 are:

1. Limiting the issuance of offsets
2. Issuing or auctioning "certificates" to permit offset development or use
3. Limiting the use of offsets

Limiting the issuance of offsets creates significant uncertainty for project developers, as demonstrated by the following simplified example. Assume that California's 49% limit (or 5% pool as a percent of the total program emissions) contains 100 offsets, and I develop a project which results in 20 credits. When I make the initial investment I have no certainty whether my project will be the first in line and receive all 20 credits, or last in line when there are no offset credits remaining. Perhaps my project will be submitted when 90 tons have already been submitted by other projects, and I will only receive 10 credits, rather than the 20 I am due. Or even worse, perhaps my project will be submitted when 150 tons

have already been submitted by other projects, so there is no chance I will get any return on my investment.

Alternatively, all projects that apply to a pool could be issued credits on a prorated basis. Assume again that there is a pool of 100 offsets available, and I develop 20 tons of emission reductions. Collectively, the market supplies 200 offsets but there is only a pool of 100 available. So each project developer gets essentially half a credit for their effort on a prorated basis. That means that I only get 10 credits for the 20 tons of reductions I develop. Again, there is no way for me to know this when I am making the initial decision to invest, so all the assumptions upon which the financials of my project have been based are undermined and there is no investment certainty (and therefore, no incentive to invest) for me as a project developer whatsoever.

These policy-related types of investment uncertainty are simply unreasonable from a project developer perspective. Project developers already assume significant project risks related to project performance (reductions actually achieved vs. expected), changes in market prices for credits, and salability of credits. While we have a variety of mechanisms for mitigating these aforementioned risks, there is no way for us to manage the political risk associated with being beholden to the size and length of the “line” of offset applicants each year to determine whether or not a project was a sound investment.

The second option, issuing or auctioning “certificates” to permit offset development or use, is problematic for a variety of reasons, most importantly because it creates an additional tradable commodity which complicates the market. Who holds the credits, the project developer or the end user? It also creates uncertainty for project developers about their ability to obtain the certificates, i.e. how will they be distributed? Would the certificates be handed out on a prorated basis depending on the number of applicants to the pool? Even “free” certificates could push up transaction costs of projects, since there is some expense associated with acquiring and transacting them. This has the potential to make marginally profitable projects (particularly those that are diffuse or small scale, e.g. urban forestry) unprofitable and therefore infeasible. Furthermore, it creates the possibility for market manipulation if some entities hoard these certificates, particularly if competitors hoard certificates to drive up prices or undermine project viability of competitors.

Auctioning the certificates would be accompanied by all the aforementioned problems as when they are distributed freely, except that the explicit cost of the credits would likely make an even broader cross-section of projects unprofitable and therefore infeasible. Furthermore, if there are no limits on how many certificates can be purchased at auction, one project developer could in theory buy up all the certificates to push other market participants out.

EcoSecurities firmly believes that the third option—applying the limit to the *use* of offsets is, while imperfect, the best approach. Limiting offset use as opposed to limiting offset issuance provides more certainty for offset project developers, since tons can be issued above the percentage limit, even if they cannot be used in that given year. Offsets can then be held over until the following year for use, or used in other jurisdictions. Therefore, project developers would still assume some risk that the credits may not be salable, but would not face the risk that credits are not issued for reductions actually achieved.

Limiting offsets instead of offset issuance would also benefit California. California can issue offsets above the 5% limit in this scenario, which could be sold into other jurisdictions while California profits from the registration and other costs associated with project development. The State could also potentially benefit from additional emission reductions in California, to the extent that credits registered in-state are from projects located in-state but sold elsewhere.

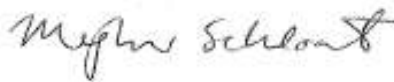
This approach to offsets is consistent with the approach of other policies and jurisdictions, e.g. the language in the Waxman-Markey Bill. The W-M Bill applies the offset limit at a facility level by taking the total number of offsets allowed in a given year (at the federal level, 2 billion), and dividing this by the overall number of credits in the program (2 billion + annual emissions for the year prior). This gives covered entities a percentage number of their total compliance obligation that can be used as offsets, which in 2012 equals approximately 30%, an ample sized portion through which an entity can reduce emissions using offsets.

In closing, we at EcoSecurities appreciate your time in reading this letter and your consideration of our comments on offset limits under AB 32. We commend the Air Resources Board staff for your dedicated and diligent efforts on such groundbreaking climate change policy. Please do not hesitate to contact EcoSecurities should you have any questions about the viewpoints in this letter.

Sincerely,



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